



Taxation of Digital Products Uniformity Project

Draft White Paper Section on Bundling

Presentation to the Work Group – September 5, 2024

(This is an incomplete draft meant to solicit feedback to develop the bundling white paper)

1. Introduction

The Digital Products Work Group was formed to draft a white paper on the issues states should consider when including digital products¹ in their sales tax base.² At their March 7, 2024 meeting, the work group voted to study bundling issues.³ As part of the larger white paper, we propose a subsection addressing bundling issues.

The primary question this section of the digital products white paper addresses is:

Does the presence of digital products in a sales and use tax base present any unique issues with respect to bundling compared to sales and use tax bases that are based on tangible personal property and services?

To address this question, this white paper (1) describes the primary approaches to the concept of bundling and their relation to digital products, (2) highlights the positives and negatives of those approaches, and (3) presents findings and recommendations. [Full summary TBD once the white paper is completed.]

State representatives, notably the work group members, and other stakeholders may review and comment on the draft to help provide guidance for policymakers.

Please direct any questions or feedback to Nancy Prosser, nprosser@mtc.gov, or Jonathan White, jwhite@mtc.gov

¹ For purposes of this MTC uniformity project, the term “digital product” means both goods and services.

² Visit the MTC project page at <https://www.mtc.gov/uniformity/sales-tax-on-digital-products/>.

³ Notes from that work group meeting are available here: <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.mtc.gov/wp-content/uploads/2024/04/Digital-Work-Group-Notes-03-7-24.pdf>

2. Table of contents

[TBD once the white paper is completed.]

3. Executive summary

[Assume a 1–2-page high-level summary.]

4. Recommendations to the states

[TBD by the work group members].

5. Why and how states have developed bundling rules

State tax administrators and taxpayers use the term “bundling” in sales and use tax systems to address situations when a nontaxable product is sold for a single price with (i.e., bundled with) one or more other taxable products, which may result in the non-taxable product being subject to tax. Taxpayers and tax administrators in states with broader sales and use taxes—one that either exempts or taxes all products—will not face as many bundling issues because it is the distinctions within the sales tax base that create the need for bundling rules.

The true object test⁴ is the original bundling rule. It is used to determine whether a transaction is classified by its taxable portion or by its nontaxable portion.⁵ Typically, the distinction is needed between taxable tangible personal property and nontaxable services or intangibles.⁶ There are also alternative tests, including

A Note on Terminology

A recurring issue when discussing bundling is terminology. Terms like distinct and identifiable, mixed transactions, separability, and others often have different meanings across jurisdictions, or two different terms have the same meaning.

Under Streamlined, a bundle must contain “distinct and identifiable” products. In other words, the parts of a purported bundle must be distinct and identifiable.

However, “distinct and identifiable” is used in Texas’s description of unrelated services with the opposite effect. Services are unrelated if, among other requirements, they are distinct and identifiable.¹ In Texas, distinct and identifiable services are excluded from taxation. Under the Streamlined rules, distinct and identifiable components are included in bundles (and taxable).

Keep in mind that terminology is not always uniform across jurisdictions.

⁴ In this whitepaper we use the term “true object test” to mean any similar terminology used by states, such as “essence of the transaction test.”

⁵ Hellerstein, Hellerstein & Appleby, *State Taxation*, § 12.08[1] (Thomson Reuters/Tax & Accounting, 3rd ed. 2001, with updates through December 2023) (online version accessed on Checkpoint (www.checkpoint.riag.com) July 11, 2024).

⁶ Hellerstein, Hellerstein & Appleby, *State Taxation*, § 12.08[1].

the mixed transactions doctrine,⁷ the incidental to service test,⁸ and the common understanding test.⁹

The true object test is not the end of it though. States have developed statutes and rules to directly define and address bundled transactions. In particular, the Streamlined Sales Tax Governing Board, Inc. (Streamlined) has developed a comprehensive set of rules for the question. It has been adopted by all Streamlined member states.¹⁰

6. Results of staff research into current state practices on bundling

A. Streamlined States

i. Streamlined Basics

As mentioned above, the Streamlined Sales Tax Governing Board, Inc. has developed a comprehensive set of rules governing bundling.¹¹ Still, there is variation among Streamlined states. Nevada is one state that has adopted the Streamlined bundling rules nearly exactly as they appear in the Streamlined Agreement.¹²

The basic bundle definition is two or more distinct and identifiable products sold for one nonitemized price.¹³ At one MTC work group meeting a participant stated it this way: “if you can’t unbundle it, it isn’t a bundle.” This observation alludes to an important distinction between the classic bundle considered by Streamlined and a single product that is not a bundle.

The classic bundle that led to the Streamlined bundling effort and rules was the cheese tray at the grocery store in which an exempt food item, cheese, is sold along with taxable reusable items like a cutting board or a cheese knife (to distinguish from what people would generally consider just wrapping and packaging material). The cheese and the cutting board are distinct and identifiable items and even if sold together, the two *could* be unbundled. On the other hand is lemonade.

⁷ See generally, *Rylander v. San Antonio SMSA L.P.*, 11 S.W.3d 484 (Tex. App. 2000); *Dell, Inc. v. Superior Ct. of San Francisco*, 159 Cal. App. 4th 911 (Cal. Ct. App. 2008); *New England Tel. & Tel. Co. v. Clark*, 624 A.2d 298 (R.I. 1993).

⁸ *Catalina Marketing Sales Corporation v. Department of Treas.*, 678 N.W.2d 619, 626 (Mich. 2004); see also, Eric Duey, *Unbundling Bundled Transactions*, 49 CONN. L. REV. 659, 679 (2016).

⁹ Hellerstein, Hellerstein & Appleby, *State Taxation*, § 12.08[2]; see also, Eric Duey, *Unbundling Bundled Transactions*, 49 CONN. L. REV. 659, 681 (2016).

¹⁰ See [Streamlined Agreement section 330.A](#) (requiring states to adopt the core definition of a bundled transaction. See also, State and Local Advisory Council, Issue Paper: Bundled Transaction, pg 11 (2006) (noting that Streamlined member states are required to adopt the provisions of Section 330(C) applying to bundling).

¹¹ See [Streamlined Agreement section 330](#) and accompanying definitions is [Appendix C, Part 1](#) of the Streamlined Agreement.

¹² Nev. Admin. Code § 372.045.

¹³ Nev. Admin. Code § 372.045(2)(a).

Lemonade is a single product, which cannot be unbundled. You cannot get the lemons back and you cannot get the sugar back.

The above paragraphs demonstrate “distinct and identifiable,” but the term is defined, though only in the negative. The definition excludes packaging materials, bags, bottles, and other similar items. The definition also excludes things “provided free of charge with the required purchase of another product” as well as items included in the purchase price.¹⁴

It is important here to note that the adage “if you can’t unbundle it, it isn’t a bundle” does not go both ways. As with bags and packaging materials, these items could easily be unbundled, but that does not mean they make a bundle as they are excluded from the taxability analysis.

“One nonitemized price” is also defined, and only in the negative. It is defined as excluding a price that is separately identified by product on a receipt or other sales-related documentation that is made available to the customer. Qualifying documentation includes invoices, bills of sale, contracts, service or lease agreements, rate cards, and other similar documentation.¹⁵

ii. Streamlined Exclusions

There are several exclusions from the Streamlined rules.

a. True object exclusion

The true object exclusion from the Streamlined bundling rules is the most interesting one. The true object exclusion states that if the taxable tangible personal property is essential to the exempt service, *and* is provided only in connection with the exempt service, *and* the true object of the entire transaction is the exempt service component, then the transaction is excluded from the Streamlined bundling rule.¹⁶ This means that even if the true object of a transaction is an exempt service, the transaction might still be treated under the Streamlined bundling rule, unless some other exception applies.

Streamlined Step-by-Step

Step 1: Is there a bundled transaction?

- Two or more distinct and identifiable products with the following not being distinct and identifiable:
 - Elements of sales price, e.g., material and labor costs
 - Packaging
 - Items offered for free
- One nonitemized price.
- Excluding any sale for which the sales price varies or is negotiable.

Step 2: Is there an exclusion?

- Exception transactions:
 - The true object is not taxable.
 - The taxable product is de minimis
 - The transaction contains specified industry products (food, drugs, etc.) and the taxable products are X% or less of the purchase price.

¹⁴ Nev. Admin. Code § 372.045(2)(c).

¹⁵ Nev. Admin. Code § 372.045(2)(d).

¹⁶ Nev. Admin. Code § 372.045(2)(b)(2).

b. De minimis exclusion

The de minimis exclusion is what it sounds like. It excludes from a bundle a transaction that includes both taxable and nontaxable products if the purchase price or sales price of the taxable product is 10 percent or less of the total purchase or sales price.¹⁷

c. Variable sales price exclusion

This exclusion excludes transactions where the sales price is variable or negotiable based on the purchaser's selections. For example, in a situation where a vendor offered "mix and match" packages where the customer got some choice in the package and the discounting depended on those choices, the Department of Revenue determined the sales price varied based on the purchaser's selections and the transaction was not a bundle.¹⁸

d. Food, drug, and medical equipment exclusion

This exclusion is a version of the de minimis rule. The exclusion states that if the transaction involves food, drugs, or certain medical equipment or devices and the purchase price or sales price of the taxable portion is 50 percent or less of the total purchase price or sales price, then the transaction is not a bundle.¹⁹ Although the language is not clear, this exemption is likely meant to apply when the transaction involves *exempt* food, drugs, or certain medical equipment or devices.

B. Non-streamlined states

Outside of the rules and definitions created by Streamlined, there are not many explicit bundling statutes out there, especially as a tax imposition. Mostly there are administrative rules and other guidance relying on the definition of sales price being inclusive enough to tax things that are sold along with tangible personal property or other taxable items. There is also the true object test.

i. The role of sales price

Many states address the issue raised by bundling in some form, whether through case law or in regulations. In both cases, states often rely on the definition of "sales price" or an equivalent term in their sales taxes. A straightforward example of this is Florida's definition of "sales price" as the total amount paid, including any services that are part of the sale.²⁰ Florida then from tax professional or personal services transactions involving taxable sales that are inconsequential and not separately stated.

Taken together, this creates a bundling rule under which any transaction that includes taxable TPP is taxable on the entire amount charged, regardless of the inclusion of nontaxable services, unless those services are both inconsequential and separately stated.

¹⁷ Nev. Admin. Code § 372.045(2)(b)(3).

¹⁸ Georgia Letter Ruling 2019-10 (Nov. 2019).

¹⁹ Nev. Admin. Code § 372.045(2)(b)(4).

²⁰ Fla. Stat. § 212.02(16).

Idaho has adopted a regulation under their statutory definitions of “retail sale,” “sale,” and “sales price.”²¹ The rule provides that when a sale of TPP includes incidental services, sales tax applies to the entire amount charged. The rule further provides that if a service transaction includes incidental TPP, the transaction is not taxable. The rule provides that the test is whether the service involved is consequential or inconsequential.

ii. Sample non-streamlined bundling rules

Colorado

Colorado imposes tax on the entire price of a bundled transaction, unless the value of the taxable item is de minimis.²² Colorado also provides that services that are otherwise excluded from sales tax are taxable if provided as part of a mixed transaction that includes the sale of TPP or taxable services.²³ Colorado law uses the term “separable” for bundling analysis. This concept is from the *A.D. Store* case.²⁴ This is a similar concept to “distinct and identifiable” under Streamlined. Colorado Special Rule 18²⁵ states that transportation charges are not taxable if they are both separable and stated separately on a written invoice. In general, the Department requires the nontaxable items to be separately stated to avoid tax if those items are separable.

Colorado Private Letter Ruling 23-004 addresses the concept of separability. The ruling describes an item as separable if its nature remains the same whether it is contracted for as part of the mixed transaction or at a later time, and purchase of the item at a later time is possible.²⁶ The ruling addressed travel experience packages that were sold for a fixed price. The ruling turned on the fact that the seller did not market or sell the parts of the package separately. The Department determined this meant the elements were not separable. Because the items were not separable, the true object test applied rather than the bundling treatment. The Department then determined the true object of the transaction was the two-day train travel experience.

Arizona

Arizona appears to have a statutory bundling provision, but it is undercut by court opinions using the true object test, or its variants, instead.

In Arizona, TPP and services that are transferred together for a single, non-segregated price are taxable on the entire amount charged, if the property is a consequential element of the transaction.²⁷

²¹ Id. Regs. § 35.01.02.011.01.

²² Colo. Prv. Ltr. Rul. No. 10-001; see also, Colo. Prv. Ltr. Rul. No. 12-006 (rescinded).

²³ Colo. Prv. Ltr. Rul. No. 23-004; see also, 1-CCR 201-4 § 39-26-102(12); -102(7)(a); *A.D. Store Co., Inc. v. Exec. Dir.*, 19 P.3d 680, 683-684 (Colo. 2001).

²⁴ *A.D. Store Co., Inc. v. Exec. Dir.*, 19 P.3d 680 (Colo. 2001) (In *A.D. Store*, the Colorado Supreme Court held that if the price of the taxable TPP can be meaningfully separated from the price of the nontaxable service, then the service was not taxable. The court then determined that alteration services performed on clothing were separable from the clothing sold and altered.)

²⁵ 1-CCR 201-5, Special Rule 18.

²⁶ Citing to *A.D. Store*, 19 P.3d at 684.

²⁷ A.R.S. § 42-5061(F); Ariz. Admin. Code § 15-5-105.

Arizona also provides that where the TPP is an inconsequential element of rendering the nontaxable service, then the entire amount is not taxed.²⁸ To qualify as an “inconsequential element:” (1) the amount paid by the service provider for the TPP must be less than 15% of the amount charged by the service provider for their service; the TPP must not be in a form that is subject to retail sale; and (3) there is no separately stated charge for the TPP.²⁹

However, when the issue came up regarding direct mail advertising, the Arizona Supreme Court applied a true object test analysis rather than applying the rules cited above.³⁰

C. True object test and variants

Codified bundling rules and the true object test are related. The true object test is the default bundling rule, and the various bundling rules are attempts at codifying the certain aspects and results of the true object test. Another way to word this is that bundling takes certain transactions, like those including two or more distinct and identifiable products, and denies those transactions treatment under the true object test. Bundling is (probably) always a statute; true object test is case law.

i. True object

Tennessee

Tennessee has had extensive development in their true object test case law, so this section will use their law to provide the basics.

In Tennessee, as in many states, the true object test is used in situations involving inseparable transfers of taxable and nontaxable components. The fact that it is used in inseparable transfers already highlights that it might not be the best to use in conjunction with bundling, as we have heard it well said that “if you can’t unbundle it, it isn’t a bundle.”

Examples of transactions subject to the true object test in Tennessee: a painting an artist was commissioned to make, discount cards, and for an example with two services, a staffing company that provides workers, which is a nontaxable service, to a company that repairs TPP, which is a taxable service.³¹

In Tennessee, there are three categories of results:³²

1: A taxable true object and any crucial, essential, necessary, consequential, or integral elements of the transaction are taxable. This is not an all or nothing result, this is saying that even with a taxable true object, only the crucial, essential, necessary, consequential, or integral things come along with it

²⁸ A.R.S. § 42-5061(A)(1); Ariz. Admin. Code § 15-5-104(B).

²⁹ Ariz. Admin. Code § 15-5-104(C).

³⁰ *Val-Pak East Valley, Inc. v. Ariz. Dep’t of Rev.*, 272 P.3d 1055 (Ariz. Ct. App. 2012).

³¹ Tenn. Ltr. Rul. 14-10.

³² Tenn. Ltr. Rul. 14-10.

for taxation. Components that are not crucial, essential, necessary, consequential, or integral are treated some other way, even though the true object is taxable.

2: A transaction with any taxable component that is crucial, essential, necessary, consequential, or integral is taxable, even if the true object is not independently taxable. This is a way to tax a transaction even if the true object is not taxable. As discussed above, under the Streamlined true object exclusion, there is a way to tax an entire transaction all even if the true object is nontaxable. This is another way, but is an opposite of Streamlined.

3: If the true object is not taxable and the taxable items are merely incidental to the true object, then the transaction is not taxable. This one is more straightforward, but still not all or nothing.

ii. Variants

Common Understanding Test³³

The common understanding test looks to the common understanding that an average purchaser would attribute to a transaction.³⁴ An early case using this method considered a provider of credit ratings that provided those rating in physical books.³⁵ The court relied on the common understanding of what was important, the rating of credit, not the books themselves.³⁶

A more modern adoption of the common understanding test can be found in *City of Boulder v. Leanin' Tree, Inc.*³⁷ There, the Colorado Supreme Court surveyed the numerous tests and eventually adopted a case-by-case approach considering the totality of the circumstances and whether the transaction is commonly viewed as a sale of service or sale of goods.

The Arizona Court of Appeals applied both the true object test and the common understanding test, with some value of the TPP versus the intangibles analysis as well.³⁸ In *Val-Pak East Valley*, the Arizona court held that two tests were considered to determine the categorization of a transaction.

The court determined the dominant purpose, or true object, of the transaction was to obtain design, mailing, and printing services, not TPP. Before moving on from the true object test, the court mentioned that the paper had little practical value without the design, printing, and mailing services, bringing in the relative value assessment as part of the true object test analysis. The court then determined that under the common understanding test no one would in the general public would conder the taxpayer to be in the paper selling business.

³³ Hellerstein, Hellerstein & Appleby, *State Taxation*, § 12.08[1]; see also, Eric Duey, *Unbundling Bundled Transactions*, 49 CONN. L. REV. 659, 681.

³⁴ Hellerstein, Hellerstein & Appleby, *State Taxation*, § 12.08[2]

³⁵ *Dun & Bradstreet, Inc. v. City of New York*, 11 N.E.2d 728 (1937).

³⁶ *Dun & Bradstreet, Inc. v. City of New York*, 11 N.E.2d 728, 731 (1937).

³⁷ *City of Boulder v. Leanin' Tree, Inc.*, 72 P.3d 361 (Colo. 2003).

³⁸ *Val-Pak East Valley, Inc. v. Ariz. Dep't of Rev.*, 272 P.3d 1055 (Ariz. Ct. App. 2012).

Overriding purpose test

In *Emery Industries, Inc. v. Limbach*, the Ohio Supreme Court adopted the overriding purpose test.³⁹ This is a version of the true object test that includes a requirement of consequential amounts of TPP as a backup.

The court held that a contract for design services provided to enable the installation of equipment was for services, not TPP despite the plans being delivered as physical plans. The court states that the overriding purpose of the buyer was to have the equipment installed and that the bid documents were inconsequential. The court disavows a contrary result in a similar case holding that the true object of a contract for engineering services was TPP.

This test seems very similar to the true object test as both rely on the subjective intent of the buyer. The overriding purpose test seems to have a consequential TPP requirement as a backup. This requirement prevents the result in the engineering services case described above by requiring that any TPP relied upon in the analysis be consequential. The court contrasted an attorney drafting a will with photography services. The court stated the latter would be a contract for TPP because the photographs are what is important (they are not inconsequential), even though the customer may have sought an accomplished photographer.

There are a variety of other approaches various courts have relied on.⁴⁰

Relevant factors (short of a separate test)

There are also a variety of factors courts have considered helpful, including: the value of TPP versus the intangibles;⁴¹ whether there was an alternative method of transfer;⁴² the length of time the information provided retains its value;⁴³ constraints on the buyer's ability to use the property;⁴⁴ what is eventually done with the TPP;⁴⁵ and whether the TPP is the product the purchaser sought.⁴⁶

³⁹ *Emery Indust., Inc. v. Limbach*, 539 N.E.2d 608 (Ohio 1989).

⁴⁰ See, e.g., *Emery Indust., Inc. v. Limbach*, 539 N.E.2d 608 (Ohio 1989) (overriding purpose test); *Hasbro Indus., Inc. v. Norberg*, 487 A.2d 124 (R.I. 1985) (real object test); *Quotron Systems, Inc. v. Comptroller of Treasury*, 411 A.2d 439 (Md. 1980) (predominant purpose test); *Bullock v. Statistical Tabulating Corp.*, 549 S.W.2d 166 (Tex. 1977) (essence of the transaction test); *WTAR Radio-TV Corp. v. Commonwealth*, 234 S.E.2d 245 (1977) (true object test).

⁴¹ *Washington Times-Herald v. District of Columbia*, 213 F.2d 23 (D.C. Cir. 1954); *Fingerhut Prods. Co. v. Comm'r of Revenue*, 258 N.W.2d 606 (Minn. 1977).

⁴² *Commerce Union Bank v. Tidwell*, 538 S.W.2d 405 (Tenn. 1976); *Bullock v. Statistical Tabulating Corp.*, 549 S.W.2d 166 (Tex. 1977).

⁴³ *Fingerhut Prods. Co. v. Comm'r of Revenue*, 258 N.W.2d 606 (Minn. 1977); *Williams Lee Scouting Service, Inc. v. Calvert*, 452 S.W.2d 789 (Tex.App. 1970).

⁴⁴ *Dun & Bradstreet, Inc. v. City of New York*, 11 N.E.2d 728 (1937).

⁴⁵ *Commerce Union Bank v. Tidwell*, 538 S.W.2d 405 (Tenn. 1976); *Sneary v. Director of Revenue*, 865 S.W.2d 342 (Mo. 1993).

⁴⁶ *Columbus Coated Fabrics Div. v. Porterfield*, 285 N.E.2d 50 (Ohio 1972); *Hasbro Indus., Inc. v. Norberg*, 487 A.2d 124 (R.I. 1985).

iii. Mixed Transactions

There are situations where the true object test is not applicable. One of these is “mixed transactions.” Mixed transactions are those where the various items being analyzed are not packaged, bundled, or intertwined enough to be viewed as one. Or, have too much independence from one another to be viewed as one. The following cases illustrate several examples of this.

Tennessee

In *Penske Truck Leasing Co. v. Huddleston*, a case predating Streamlined, the Tennessee Supreme Court held that a long-term lease agreement and fuel agreement included in a single contract warranted separate analysis for sales tax.⁴⁷ The fuel was optional, but if the option was taken, the fuel was paid for in advance, at the time of the lease. The fuel option did not affect the price of the truck lease. The court distinguished the case from its *Magnavox* case, where the vendor of leased trucks was required to provide fuel with the trucks in all cases.⁴⁸ The court’s holding in *Penske* meant that the lease of the trucks and the sale of the fuel were considered independently for sales tax purposes, rather than being analyzed as a single contract using the true object test.

Texas

In *Rylander v. San Antonio SMSA L.P.*,⁴⁹ the court considered transactions for network equipment and engineering services to configure the equipment. The equipment and services were priced separately but invoiced together. The court held the equipment and the engineering services were independently desired and independently provided, were readily separable, and neither was “incident” to the other. The result was that the two things are analyzed separately for taxability. In *SMSA*, the Texas court cited to *New England Tel. & Tel. Co. v. Clark*,⁵⁰ a Rhode Island case, extensively. In *Clark*, the issue and result were similar.

California

Finally, there is *Dell, Inc. v. Superior Ct. of San Francisco*,⁵¹ with a similar result. The California court held that Dell’s computers and warranty contracts are mixed transactions that are severable and partially taxable. *Dell* provides three potential situations:

- (1) TPP is true object and whole thing is taxed;
- (2) service is true object and entire thing is not taxed; and
- (3) transaction is a mixed transaction and is severable and partially taxable (true object test does not apply).⁵²

⁴⁷ *Penske Truck Leasing Co. v. Huddleston*, 795 S.W.2d 669 (Tenn. 1990).

⁴⁸ *Magnavox Consumer Electronics v. King*, 707 S.W.2d 504 (Tenn. 1986).

⁴⁹ *Rylander v. San Antonio SMSA L.P.*, 11 S.W.3d 484 (Tex. App. 2000).

⁵⁰ *New England Tel. & Tel. Co. v. Clark*, 624 A.2d 298 (R.I. 1993).

⁵¹ *Dell, Inc. v. Superior Ct. of San Francisco*, 159 Cal. App. 4th 911 (Cal. Ct. App. 2008).

⁵² Citing to *In re Advance Schools, Inc.*, 2 B.R. 231, 235 (Bankr. N.D.Ill. 1980).

Dell and *SMSA* can be distinguished if we want to. In *SMSA* (and *Clark*), the engineering services and the equipment had value separately. The result of the case depended on them being independently desired and independently provided. This made them not “incident” to one another. In *Dell*, the add-on warranties were valueless without a Dell computer, they couldn’t be used for other computers. So would the result in *Dell* be the same under Texas’s rule? Either way, in both cases the true object test was inappropriate.

7. Results of stakeholder discussions about bundling and digital products

At the July 30, 2024 Uniformity Committee meeting in Denver, CO, the digital products work group chair, vice-chair, and staff reported on the stakeholder calls conducted with taxpayers, their representatives, and other non-state representatives to solicit input on their experiences and information they want to share with the work group about bundling and digital products.⁵³

A. Stakeholders who provided input

i. Academics

Andrew Appleby, Stetson College of Law

ii. Streamlined Representatives

Craig Johnson & Christie Comanita (work group ex officio members)

Sherry Hathaway & Michael Ward (TN)

iii. Taxpayers

Amazon – Jessie Eisenmenger & Roger Price

Apple – Terry Ryan and Sheila Bayley

Charter Communications – Brandi Drake

iv. Practitioners & Taxpayer Representatives

Eversheds Sutherland – Michele Borens and Charlie Helms

Kranz & Associates – Carolyn Kranz

Moss Adams – Phil Horwitz

MultiState Associates – Deborah Bierbaum

Yetter Tax – Diane Yetter

Pillsbury Winthrop Shaw Pittman - Zach Atkins

v. Organizations & Compliance Vendors

Avalara – Scott Peterson (via comments to the press)

Council On State Taxation – Fred Nicely

SofTec – Mark Nebergall

⁵³ Add cite to the slides/presentation.

B. Stakeholder perspectives

This subsection presents a general summary of the stakeholder perspectives without specific attribution. Some stakeholder perspectives are noted elsewhere in the paper and identified as such.

i. General observations

Many stakeholders explained that confusion exists when working with bundling issues generally across the states in addition to when digital products are part of a bundle. The confusion frequently concerns what is a bundle versus what is a single product with multiple attributes versus when does a situation most accurately call for application of the true object test.

Some stakeholders say bundling with digital products is more difficult than with other products. That said, sellers like bundles: it creates perceived value to purchasers to receive a group of items for one price. Marketing staff, who are not generally thinking about taxability issues, may want to sell a product for a single price that does not require tax being added to be in line with or look better than what their competitors offer. Thus, bundles are here to stay.

Digital apps frequently have various components/attributes which create confusion as to whether an app is a bundled product or not. More than one stakeholder noted that all digital services have some component of software. It was also noted that any digital attribute can be removed from a digital product, so digital products are not like tangible products. Think in terms of the lemonade example in section X of this white paper: once made, you can't get the sugar back, can't get the lemon juice back, can't get the water back. If you make digital lemonade, you can get the sugar back, the lemon juice back, and the water back.

Stakeholders made mention of Internet Tax Freedom Act (ITFA)⁵⁴ definitions and the implications of the ITFA accounting rule. Some stakeholders left an impression that taxpayers and states are not generally as aware of the ITFA accounting rule as tax practitioners are.

Software maintenance services come up frequently in bundles.

Streaming products can create disputes and the need for additional information. Tax agencies often ask about percentages of different parts of a streaming product; tax agency staff may request the percentage of downloads vs streamed views to determine taxability. Some stakeholders said the ability to download an otherwise streaming digital product should not be considered downloaded software, which can be a taxable item in states, because in their view the true object is the streaming.

ii. Coding compliance software

Stakeholders were aligned that coding bundled products with the correct taxability determination is very challenging for taxpayers who customize their sales tax compliance systems and for sales tax

⁵⁴ Details on the relevant ITFA language are presented in section X of this white paper.

compliance software vendors who work with taxpayers. One taxpayer stated it had been working for years with its third-party software provider to customize its platform to address the bundled products it sells, and further stated that representatives for that platform told the seller the platform had been working for years and was still not able to offer any standardized product and taxability codes for bundled products because of the complexity and lack of uniformity across the states.

iii. Case-by-case determinations

Stakeholders reported negotiating with states to allow sellers and tax agencies to determine what taxability determination controls in specific situations. They also reported requesting letter rulings to address the taxability of bundled products when state guidance is not otherwise clear. Sometimes long-term negotiations with state (as in years) have occurred with taxpayers or their representatives providing extensive information to allow the tax agency to make a determination relating to a bundled product.

iv. Invoices vs. contracts

Stakeholders noted that when analyzing facts relating to a bundled transaction, or to make a determine whether the item sold is a bundled product, details may exist in a contract about what is being purchased and how the product works to help auditors and tax agency staff. A lack of such detail may result in the unwillingness of tax agency staff to allow unbundling through an accounting rule.

8. Federal law considerations

Two federal laws contain language addressing bundling issues that taxpayers, tax administrators, and policy makers must keep in mind. Below we present the relevant language from each law, with links to the full language. State tax laws or other guidance may also reflect these provisions.

A. Internet Tax Freedom Act (47 USC 151 note)

The relevant language relating to bundled telecommunications products is as follows. The ITFA also includes definitions and other provisions that should be consulted to fully understand to what services the law applies.

SEC. 1106. ACCOUNTING RULE.

(a) In General.-If charges for Internet access are aggregated with and not separately stated from charges for telecommunications or other charges that are subject to taxation, then the charges for Internet access may be subject to taxation unless the Internet access provider can reasonably identify the charges for Internet access from its books and records kept in the regular course of business.”

(b) Definitions.-In this section:

(1) Charges for internet access.-The term 'charges for Internet access' means all charges for Internet access as defined in section 1105(5).

(2) Charges for telecommunications.-The term 'charges for telecommunications' means all charges for telecommunications, except to the extent such telecommunications are purchased, used, or sold by a provider of Internet access to provide Internet access or to otherwise enable users to access content, information or other services offered over the Internet.

B. Mobile Telecommunications Sourcing Act (Public Law 106-252—July 28, 2000)

The relevant language relating to bundled telecommunications products is as follows. The MTSA also includes definitions and other provisions that should be consulted to fully understand to what services the law applies.

§ 123. Scope; special rules

....

(b) **ADDITIONAL TAXABLE CHARGES.**—If a taxing jurisdiction does not otherwise subject charges for mobile telecommunications services to taxation and if these charges are aggregated with and not separately stated from charges that are subject to taxation, then the charges for nontaxable mobile telecommunications services may be subject to taxation unless the home service provider can reasonably identify charges not subject to such tax, charge, or fee from its books and records that are kept in the regular course of business.

(c) **NONTAXABLE CHARGES.**—If a taxing jurisdiction does not subject charges for mobile telecommunications services to taxation, a customer may not rely upon the nontaxability of charges for mobile telecommunications services unless the customer's home service provider separately states the charges for nontaxable mobile telecommunications services from taxable charges or the home service provider elects, after receiving a written request from the customer in the form required by the provider, to provide verifiable data based upon the home service provider's books and records that are kept in the regular course of business that reasonably identifies the nontaxable charges.

9. Examples of digital products in the marketplace and bundling issues.

In this subsection we identify examples of bundles provided from staff research, stakeholder discussions, and work group state representatives.

[Question: Possible next step is to take some of these examples and apply the Streamlined test to see what happens to determine if the Streamlined approach is sufficient to handle digital products.]

A. Staff Research Examples

The quintessential example under Streamlined is a food platter from the grocery store, it contains exempt food and a taxable cutting board and small knife. Distinct and identifiable items and one nonitemized price are the only requirements. No interdependency is required.

An example further afield of the original Streamlined bundling intention is from Rhode Island, a Streamlined state. The Department considered a subscription giving customers unconditional access to a variety of products, including expedited shipping, streaming video, electronic books, streaming music, photo storage, and access to video games. The Department determined the subscription was a bundle because it bundled goods, services, and other benefits that were distinct and identifiable together for one non-itemized price.⁵⁵

Another example, this time from Iowa, with the opposite result. Iowa considered a product offering remote storage services and a virtual computing environment that allowed customers to run applications. Part of the cost was “data transfer fees” based on usage that were only charged in connection with other services. Taxpayer itemized the data transfer fees separately. The Iowa Department of Revenue determined the charges for data transfer fees were not for the sale of a separate item. The Department stated the fees were “included in the sales price.”⁵⁶

One more example, this time from a letter ruling. The taxpayer “develops and sells consumer electronics, computer software, online services, and related support” and some third-party digital content and applications. The taxpayer offered “preselected packages” as well as “custom packages.” With custom packages purchasers could choose what was included in the package and the taxpayer offered discounts to encourage its customers to buy custom packages. The taxpayer stated there would be no individual prices shown to the customer.

The Department ruled the preselected packages were bundles while the custom packages were not bundles. The custom packages were not bundles only because the sales price varied based on the purchaser’s choices.⁵⁷

B. Stakeholder Examples

1. Digital codes entitle the buyer to digital products, services, and tangible personal property, or some combination. An example is a digital code that entitles the purchaser to a streaming movie and a bag of chips.
2. Free items may be given away with a digital product that is sold. An example is a streaming concert video and t-shirt.

⁵⁵ Rhode Island Dec. Rul. Req. No. 23017-01 (March 31, 2017).

⁵⁶ Iowa Declaratory Order 2018-300-2-0508 (Feb. 5, 2019).

⁵⁷ Georgia Letter Ruling 2019-10 (Nov. 2019).

3. Exercise equipment sold with streaming video services.
4. Software maintenance comes up frequently in bundles.
5. Concerning streaming services, stakeholders reported that often states ask about percentages of different parts of the service, such as the percentage of downloads versus streamed views to determine taxability. Some stakeholders say the ability to download an otherwise streaming digital product should not be considered downloaded software; the true object is the streaming.

C. Work Group Member Examples

1. Assume a state does not tax software as a service but does tax software as TPP. What should be the taxability outcome if a seller of SaaS includes with the subscription an app that allows a purchaser to more easily access the SaaS platform?
2. Charges for personal services (e.g., training or consulting) or a membership to a trade or professional organization that include access to a digital library of forms, templates, articles, and/or training videos.
3. Vendor's nonitemized offering includes the following:
 - A. The right to use an online portal to access the vendor's proprietary digital research library,
 - B. The right to receive personal consulting from professional analysts, and
 - C. The right to view prerecorded online presentations, meetings, or workshops
4. Vendor's nonitemized offering includes the following:
 - A. The right to access a Communications As a Service (CaaS) platform, which includes access to use VOIP, SMS/MMS texting through IP protocol, instant messaging and audio/video conferencing tools;
 - B. The ability to store and manage data (storage and management of communication data); and
 - C. The ability to integrate (e.g., through an Application Programmable Interface) the software platform with other 3rd party software.
5. Vendor's nonitemized offering includes following:
 - A. Lease of a live-stream camera with unlimited 4G LTE Data
 - B. A web-based platform to access the live video streaming of a location (e.g., construction site)
 - C. The ability to control the camera through customer's computers or electronic devices.
 - D. Unlimited storage of videos
 - E. Access to weather data
 - F. Allows the customer to create time-lapsing videos/photos

6. Vendor's nonitemized offering is the sale of a Non-Fungible Token that provides the owner with the following:

- A. Free admission to a set number of music concerts annually – (sourced to respective state)
- B. Access to in-person educational events
- C. Lifetime subscription to video streaming service
- D. Lifetime subscription to downloadable software
- E. Lifetime subscription to music streaming service

7. Vendor's nonitemized offering is the sale of remote access software, providing users with the following:

- A. The right to exclusively use the software product remotely;
- B. Users can download an application (e.g., mobile, desktop, tablet) that provides access to the vendor's remote access software. The downloaded application does not include any offline functionality for the user; and
- C. The ability to create 3D renderings of a building or structure that can be downloaded or shared via email.

8. Vendor's nonitemized offering is the sale of remote access software, providing users with the following:

- A. The right to use the software product remotely;
- B. Users can download an application (e.g., mobile, desktop, tablet) that provides access to the vendor's remote access software. The downloaded application includes various offline functionalities when not connected to the vendor's platform, such as:
 - i. The ability for the user to take pictures within the application installed on their device
 - ii. Data storage within the user's device
 - iii. Geolocation tracking features, such as:
 - a. Location history logging
 - b. The ability to tag the location where photos are taken or data is collected
- C. The ability to create 3D renderings of a building or structure that can be downloaded or shared via email.

9. College Application Platform — Ready for School

The Taxpayer provides an online application platform (Ready for School), which is a SaaS platform. Ready for School is a SaaS platform used by schools for two purposes. The first, Best Document Admin (BDA) is for prospective students to send in their application materials and pay deposits. The second, Easy Document Review (EDR) is for the educational institution to review the applications. Each of these functions is a separate SaaS platform used by the school and each is sold for one nonitemized price.

The Taxpayer summarizes the BDA SaaS platform as comprising four distinct components: (1) Document Processing (for applicants' applications), (2) Data Hosting (for applicants' information), (3) Payment Processing (for applicants to pay), and (4) Administrative Tools (for school to view, search, and retrieve applicants' data), which are sold together for one nonitemized price. The Taxpayer asserts that because of the components' separate functionality, the BDA is not a single product. The Taxpayer argues the component parts are distinct and identifiable products. The Taxpayer argues that the BDA SaaS platform is a bundle because it has four features: document processing, data hosting, payment processing, and administrative tools. The Taxpayer claims that each of the four features is an individual product. Additionally, the Taxpayer argues that the first three components listed above qualify for specific exclusions from tax. The Taxpayer argues the administrative tools, while arguably taxable, have a cost relative to the entire package that is de minimis. Alternatively, the Taxpayer argues the true object of the administrative tools, that consists taxable products such as electronic search functionality and data processing, is exempt data processing. Or, alternatively, the administrative tools are a bundle and the taxable products are de minimis.

The second SaaS platform used by schools is the Easy Document Review platform (EDR), which manages the entire application review process online. This platform can be purchased separately from BDA. EDR collects all reviewers' scores and comments into a single location. Applications are routed to the appropriate department. Built-in search tools make it easy for evaluators to retrieve and compare applications. EDR is customized for each educational institution based on their unique needs. EDR fully integrates several other Ready for School SaaS platforms, including those for potential students to upload letters of recommendation, verify credentials, and solicit prospective students to apply. Customers would pay for each additional platform separately. All data shared between the platforms is automatic. The EDR platform is also sold for one nonitemized price. The Taxpayer argues that EDR is single product, remote access prewritten software exempt as customization of prewritten software.

Whether someone is an employee of the university or a prospective student, they log onto the same Ready for School SaaS platform and have access to all the different platforms — BDA, EDR, or any additional platforms into which the customer has opted into. When Ready for School bills their customers, they itemize their invoices with a price for each individual platform that is integrated into the Ready for School SaaS platform.

10. Online Banking Platform — GreenThumb

GreenThumb is an online banking platform built by the Taxpayer that allows member of financial entities (FT) to provide a variety of features to their customers including: paying bills, accessing electronic account statements, making balance transfers, accessing credit card accounts, checking their available credit, reviewing account data, ordering statements for the preceding year, requesting replacement cards and PIN numbers, updating account contact information, requesting a current

credit score, initiating inquiries about payments and transactions, and reporting a lost or stolen card. To provide all these services, the Taxpayer retrieves data from a variety of databases. The Taxpayer maintains a website that hosts and manages the data pulls for each of the FT's selected options. Each individual FT selects its own preferences and options available for their customers separately.

The Taxpayer provides representative monthly billing statements to the FTs that include: a fee per unique user, a custom programming fee, a monthly maintenance fee, and separate charges for cardholder statement requests, and reporting lost/stolen cards. The Taxpayer argues that the GreenThumb platform, is a single product, that qualifies for an exclusion from tax for payment processing service. The Department has determined that some of the features, if sold alone, would be taxable digital services.

The Taxpayer charges the individual TF's one nonitemized, but scalable, priced based on the number of users of the service. The Taxpayer bills for access to GreenThumb, which is an online banking platform. The membership fee per user for GreenThumb includes all the services that comprise the program, such as paying bills, accessing electronic account statements, and making balance transfers. Additionally, the Taxpayer charges separately for services related to GreenThumb, such as custom programming fee, a monthly maintenance fee, and separate charges for cardholder statement requests, and reporting lost/stolen cards.

10. Approaches to addressing bundling issues

In this section of the white paper we identify existing approaches to bundling used in the states.

A. Tainting rule

Definition: Any taxable component in a bundle means the whole bundle is taxable.

- i. Pros: Easy for sellers to apply and explain to purchasers; less audit risk.
- ii. Cons: Purchasers may push back and not want to pay tax on the full amount.
- iii. Stakeholders comments: Some like it and others do not like it. It seems to depend on the nature of a taxpayer's business model and industry.

B. De minimis rule

A de minimis rule is the most likely exception to the tainting rule. A tainting rule will pick up every transaction with any taxable TPP, no matter how little taxable TPP is involved. Some results, or potential results at the proposal phase, will seem unfair to almost everyone. Imagine a nontaxable car wash service where the tires are treated with Armor All®. The Armor All® is not washed off, it goes down the road with the car. TPP was transferred with the service, making the entire charge taxable. Whereas the competing carwash that does not treat tires with Armor All® the times will avoid tax. Such results will quickly lead to a de minimis rule.

However, other rules may also lead to a de minimis rule. For example, the Streamlined rules do not impose a pure tainting regime, but still contain a de minimis exclusion. In addition, here are questions that arise when thinking about using a de minimis rule:

- i. Can taxability be determined based on verifiable cost information of the bundled products?
 - ii. What costs control – input or output costs? May be harder to determine in the digital realm when there are fewer comparison products available.
 - iii. What should the threshold be? Is 5-10% too low to make a difference? Is 20% better to allow taxpayers and tax administrators to feel more comfortable about the outcome?
 - iv. What is the philosophy behind any de minimis rule? Does the use of a de minimis rule make it difficult for a bundle to escape taxation once something taxable is included in the bundle? Does a de minimis rule create fairness? If so, should it should be high enough that when the de minimis amount is exceeded it won't seem unreasonable to tax the entire cost of the bundle?
- i. Pros:
- ii: Cons:
- iii. Stakeholders comments: Some like it and others don't. It seems to depend on the nature of a taxpayer's business model and industry.

C. Streamlined Agreement and related rules

- i. Pros:
- ii: Cons:
- iii. Stakeholder comments: Some say Streamlined has the best approach to bundling and covers digital products, so states should look no further and not create any other options for bundling rules. Others say the Streamlined approach is good but could use an update for digital products since they were not considered when the rules were developed. Still others say Streamlined does not cover digital products because digital components are not distinct and identifiable (a condition under SST to be a bundle). Some say the “distinct product” concept from Streamlined is hard to distill with digital products; therefore, the Streamlined approach is unhelpful. Finally, even with any shortcomings, stakeholders indicated that Streamlined states are easier to navigate on bundling issues than non-Streamlined states.

D. Accounting rule (aka the unbundling rule)

Sellers can charge a single price for a bundled product and only collect tax on the taxable parts based on a reasonable position consistently taken and documented in books and records.

- i. Pros: The preferred approach of the telecom industry; also memorialized in ITFA and MTSA federal laws. May work well for businesses that want to market a single price for a product it thinks is important for market share.
- ii. Cons: May have more audit risk. Not easy for third party compliance vendors to program in their systems. Definition of “bundle” is critical.
- iii. Stakeholder comments: Telecommunication companies prefer the accounting rule, which helps address their sale for one price of phone, internet, and cable service for one price. The rule is part of the Internet Tax Freedom Act and Mobile Telecommunications Sourcing Act. (See more detailed information in subsection x of this white paper). It is also part of many state laws.⁵⁸ Stakeholders reported with respect to the telecommunications industry it creates no disputes in audits across the states. Stakeholders further explained that the accounting rule can be helpful for staying in compliance with non-tax regulations.

However, stakeholders also mentioned that the accounting rule is less transparent for purchasers who have a harder time understanding how tax is calculated and creates more audit risk for sellers if they do not get the accounting right. Some say everyone should be able to use the accounting rule if it fits their business needs.

E. True object

As noted elsewhere in this whitepaper, this is the default rule for many states and taxpayers when starting a taxability analysis once they determine they have a bundled good or service. Yet questions arise such as: Whose perspective controls the true object analysis? The seller’s or purchaser’s? Some stakeholders suggested states consider using a “reasonably prudent buyer” perspective to help everyone at least start the analysis from the same perspective.

Stakeholder comments: Some say use the true object instead of a tainting rule because it is more accurate. Others say the true object test is too subjective and a more objective test, based for example on comparable cost data across similar industries, is more accurate. Several noted that when working with the true object test disputes with tax agency staff can arise over whether the seller or purchaser perspective controls what is the true object of the sale. Some suggested greater clarity could be achieved by states using a “reasonably prudent buyer” standard for determining the true object of a bundled transaction.

⁵⁸ For example, Tex. Tax Code Ann. § 151.025(d) states: “If any nontaxable charges are combined with and not separately stated from taxable telecommunications service charges on the customer bill or invoice of a provider of telecommunications services, the combined charge is subject to tax unless the provider can identify the portion of the charges that are nontaxable through the provider’s books and records kept in the regular course of business. If the nontaxable charges cannot reasonably be identified, the charges from the sale of both nontaxable services and taxable telecommunications services are attributable to taxable telecommunications services. The provider of telecommunications services has the burden of proving nontaxable charges.”

F. Industry specific:

- i. Already present in the Streamlined approach
- ii. Telecom industry in all states benefits from the accounting rules in ITFA and MTSA

Beyond the provisions of the Streamlined agreement relating to specific industry treatment of bundled products, only the telecommunications industry was mentioned as having the accounting rule as its norm across the country and based on both the Internet Tax Freedom Act and the Mobile Telecommunications Sourcing Act. See also subsection (?) of this white paper.

G. Deciding between the various approaches

- i. Questions states will have to answer to determine their approach
- ii. Balancing the pros and cons of each approach
- iii. Supporting provisions for each approach

11. Lessons learned / findings and conclusions

As stated in the introduction, the primary question this section of the digital products white paper addresses is:

Does the presence of digital products in a sales and use tax base present any unique issues with respect to bundling compared to sales and use tax bases that are based on tangible personal property and services?

The work group presents findings and conclusions to highlight the issues and questions policy makers should consider to create a coherent policy framework for bundling in the digital space. There are two new approaches to bundling that states may want to consider based on input from stakeholders.

A. Definitions

What is a bundle versus what is a single digital product composed of a group of digital attributes? In the digital realm, digital components can be easily stripped out or added, which can lead to disputes and long discussions with tax agency staff who may be skeptical about the nature of the product and how it works.

B. Tax software compliance coding

Bundling issues can make coding compliance systems much harder. From discussions with stakeholders, the technology is not the problem; it's the complexity of products and states approaches with the multitudes of bundling approaches that exist. If states have a percentage rule

that can make things easier provided determining what the percentages of the various parts of the bundle are easily determined, such as the Streamlined bundling provision discussed in subsection ?? of this whitepaper that establishes a taxability percentage.

C. New possible bundling approaches

Stakeholders identified two new possible bundling approaches the work group may want to further discuss and include in the white paper.

i. Use a hierarchy or decision tree

One stakeholder suggested creating a new approach based on a hierarchy that helps taxpayers and tax administrators think through various factors and fact patterns, with perhaps the ultimate default in the hierarchy/decision tree concluding the bundle is taxable. No specific example of what that might look like was provided, so many options are possible. It could resemble a list of options, as presented in this white paper, to approach bundling issues given that different fact patterns might lend themselves to better approaches than others. Or, a state could identify what approaches to bundling they would consider or not.

ii. Apply a taxability percentage

Streamlined section 330 concerns “Bundled Transactions.” Subsection 330. D. 3. could be used as a model to develop an approach that would provide in certain circumstances that 50% of the transaction will be deemed taxable. This could be phrased as a rebuttable or an irrebuttable presumption. One stakeholder suggested an example of a subscription service that allows the subscriber to select products from a menu that include both digital and non-digital products. Payments would typically be made in advance and neither the customer nor the seller would know what allocation may be appropriate at the time of billing. Ease of administration might suggest a single taxable percentage for the monthly charge, regardless of the actual usage in any month.

For background, Streamlined section 330 provides in relevant part as follows:

D. In the case of a transaction that includes an “optional computer software maintenance contract” for prewritten computer software and the state otherwise has not specifically imposed tax on the retail sale of computer software maintenance contracts, the following provisions apply:

.....

2. If an optional computer software maintenance contract only obligates the vendor to provide support services, it will be characterized as a sale of services and a state may use any of the methods provided under subsection (D)(3) to determine the taxable and nontaxable or exempt portions.

3. If an optional computer software maintenance contract is a bundled transaction in which both taxable and nontaxable or exempt products that are not separately itemized on the invoice or similar billing document, then states shall elect one of the following tax treatments:

....

d. The contract shall be characterized as twenty, thirty, forty or fifty percent taxable or eighty, seventy, sixty and fifty percent nontaxable or exempt respectively, as selected by each member state.

4. With respect to states that elect the method described in subparagraph 3(b):

a. Such states may prescribe the use of such reasonable methods as it deems appropriate, and

b. The method selected by the seller shall be binding on the purchaser.

The accompanying rule to Streamlined Agreement section 330.3 (Allocations with respect to Prewritten Computer Software Maintenance Contracts) provides: “Each state may elect one uniform percentage within the range allowed under Section 330 (D)(3)(d) for allocating between taxable and nontaxable or exempt products.”

12. Appendices

[TBD if needed]